The Reality of Investment Risk

When it comes to risk, here's a reality check: All investments carry some degree of risk. Stocks, bonds, mutual funds and exchange-traded funds can lose value, even all their value, if market conditions sour. Even conservative, insured investments, such as certificates of deposit (CDs) issued by a bank or credit union, come with inflation risk. They may not earn enough over time to keep pace with the increasing cost of living.

What Is Risk?

When you invest, you make choices about what to do with your financial assets. Risk is any uncertainty with respect to your investments that has the potential to negatively affect your financial welfare.

For example, your investment value might rise or fall because of market conditions (market risk). Corporate decisions, such as whether to expand into a new area of business or merge with another company, can affect the value of your investments (business risk). If you own an international investment, events within that country can affect your investment (political risk and currency risk, to name two).

There are other types of risk. How easy or hard it is to cash out of an investment when you need to is called liquidity risk. Another risk factor is tied to how many or how few investments you hold. Generally speaking, the more financial eggs you have in one basket, say all your money in a single stock, the greater risk you take (concentration risk).

In short, risk is the possibility that a negative financial outcome that matters to you might occur.

There are several key concepts you should understand when it comes to investment risk.

Risk and Reward. The level of risk associated with a particular investment or asset class typically correlates with the level of return the investment might achieve. The rationale behind this relationship is that investors willing to take on risky investments and potentially lose money should be rewarded for their risk.

In the context of investing, reward is the possibility of higher returns. Historically, stocks have enjoyed the most robust average annual returns over the long term (just over 10 percent per year), followed by corporate bonds (around 6 percent annually), Treasury bonds (5.5 percent per year) and cash/cash equivalents such as short-term Treasury bills (3.5 percent per year). The tradeoff is that with this higher return comes greater risk: as an asset class, stocks are riskier than corporate bonds, and corporate bonds are riskier than Treasury bonds or bank savings products.

Exceptions Abound

Although stocks have historically provided a higher return than bonds and cash investments (albeit, at a higher level of risk), it is not always the case that stocks outperform bonds or that bonds are lower risk than stocks. Both stocks and bonds involve risk, and their returns and risk levels can vary depending on the prevailing market and economic conditions and the manner in which they are used. So, even though target-date funds are generally designed to become more conservative as the target date approaches, investment risk exists throughout the lifespan of the fund.

Averages and Volatility. While historic averages over long periods can guide decision-making about risk, it can be difficult to predict (and impossible to know) whether, given your specific circumstances and with your particular goals and needs, the historical averages will play in your favor. Even if you hold a broad, diversified portfolio of stocks such as the S&P 500 for an extended period of time, there is no guarantee that they will earn a rate of return equal to the long-term historical average.

The timing of both the purchase and sale of an investment are key determinants of your investment return (along with fees). But while we have all heard the adage, “buy low and sell high,” the reality is that many investors do just the opposite. If you buy a stock or stock mutual fund when the market is hot and prices are high, you will have greater losses if the price drops for any reason compared with an investor who bought at a lower price. That means your average annualized returns will be less than theirs, and it will take you longer to recover.

Investors should also understand that holding a portfolio of stocks even for an extended period of time can result in negative returns. For example, on March 10, 2000, the NASDAQ composite closed at all-time high of 5,048.62. It has only been recently that the closing price has approached this record level, and for well over a decade the NASDAQ Composite was well off its historic high. In short, if you bought at or near the market’s peak, you may still not be seeing a positive return on your investment. Investors holding individual stocks for an extended period of time also face the risk that the company they are invested in could enter a state of permanent decline or go bankrupt.

Time Can Be Your Friend or Foe

Based on historical data, holding a broad portfolio of stocks over an extended period of time (for instance a large-cap portfolio like the S&P 500 over a 20-year period) significantly reduces your chances of losing your principal. However, the historical data should not mislead investors into thinking that there is no risk in investing in stocks over a long period of time.

For example, suppose an investor invests $10,000 in a broadly diversified stock portfolio and 19 years later sees that portfolio grow to $20,000. The following year, the investor’s portfolio loses 20 percent of its value, or $4,000, during a market downturn. As a result, at the end of the 20-year period, the investor ends up with a $16,000 portfolio, rather than the $20,000 portfolio she held after 19 years. Money was made—but not as much as if shares were sold the previous year. That’s why stocks are always risky investments, even over the long-term. They don’t get safer the longer you hold them.

This is not a hypothetical risk. If you had planned to retire in the 2008 to 2009 timeframe—when stock prices dropped by 57 percent—and had the bulk of your retirement savings in stocks or stock mutual funds, you might have had to reconsider your retirement plan.

Investors should also consider how realistic it will be for them to ride out the ups and downs of the market over the long-term. Will you have to sell stocks during an economic downturn to fill the gap caused by a job loss? Will you sell investments to pay for medical care or a child's college education? Predictable and unpredictable life events might make it difficult for some investors to stay invested in stocks over an extended period of time.

Managing Risk

You cannot eliminate investment risk. But two basic investment strategies can help manage both systemic risk (risk affecting the economy as a whole) and non-systemic risk (risks that affect a small part of the economy, or even a single company).

- Asset Allocation. By including different asset classes in your portfolio (for example stocks, bonds, real estate and cash), you increase the probability that some of your investments will provide satisfactory returns even if others are flat or losing value. Put another way, you're reducing the risk of major losses that can result from over-emphasizing a single asset class, however resilient you might expect that class to be.
- Diversification. When you diversify, you divide the money you've allocated to a particular asset class, such as stocks, among various categories of investments that belong to that asset class. Diversification, with its emphasis on variety, allows you to spread you assets around. In short, you don't put all your investment eggs in one basket.

Hedging (buying a security to offset a potential loss on another investment) and insurance can provide additional ways to manage risk. However, both strategies typically add (often significantly) to the costs of your investment, which eats away any returns. In addition, hedging typically involves speculative, higher risk activity such as short selling (buying or selling securities you do not own) or investing in illiquid securities.

The bottom line is all investments carry some degree of risk. By better understanding the nature of risk, and taking steps to manage those risks, you put yourself in a better position to meet your financial goals.